No. 03-932

Supreme Court, U.S.
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Supreme Court of the United States

DURA PHARMACEUTICALS, INC.; CAM L. GARNER; JAMES W. NEWMAN; CHARLES W. PRETTYMAN; WALTER F. SPATH; JULIA R. BROWN; JOSEPH C. COOK, JR.; and MITCHELL R. WOODBURY,

Petitioners,

v.

MICHAEL BROUDO; BALDEV S. GILL; LARRY MORGAN IRA; LEONID SHVARTSMAN, (for G&S partnership); NEIL SISKIND; ROBERTA SPECK; BRENT VOGT, on behalf of themselves and all others similarly situated,

Respondents.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF STATE OF NEW JERSEY DEPARTMENT OF THE TREASURY AND ITS DIVISION OF INVESTMENT AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICUS CURIAE[1]

The State of New Jersey Department of the Treasury and its Division of Investment ("Division"), with $79.4 billion invested in the public markets under management, is among the 50 largest public or private money managers in the United States. The pension funds constitute $67.5 billion of the Division's managed assets, which represent the retirement plans for over 700,000 active and retired employees. The remaining monies are managed in over 170 additional separate funds, such as the NJ Cash Management Fund, the Deferred Compensation Fund, the Supplemental Annuity Collective Trust Fund and a portion of the NJBEST College Savings Plan.

As a large public institutional investor, the Division and the investors and pensioners it serves have a great interest in the proper interpretation and enforcement of the securities laws. The issue raised in this case – the standard for pleading loss causation in securities fraud actions – is of great importance to investors. Additionally, the Division currently serves as lead plaintiff in six pending securities class actions, and the Court's decision on loss causation in this matter may bear directly on those suits, even those in which the pleading stage has passed.

Accordingly, it is respectfully submitted that the Division's views can assist the Court in considering this matter.

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1. Pursuant to this Court's Rule 37.6, the State of New Jersey Department of the Treasury and its Division of Investment states that no counsel for any party authored this brief in whole or in part, and no person or entity other than amicus curiae, or its counsel, has made a monetary contribution to the preparation or submission of brief. Pursuant to Rule 37.3, the parties' letters of consent to the filing of this brief have been lodged with the Clerk.

INTRODUCTION

This case is about pleading. It is not, as petitioner's supporting amici would have one believe, about the efficacy of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), nor is it one in which this Court is called upon to divine congressional intent from an ambiguously worded statute. In passing the PSLRA, Congress created a detailed and complex legislative scheme to accomplish its goals, including a heightened pleading standard for certain elements of securities fraud claims. Congress did not say that loss causation must be pleaded and it did not define how to do so. Stripped of hyperbole and freed from the specter of "frivolous litigation," the question presented in this case may be resolved by simple adherence to the time-tested rules of pleading and study of the common law conception of loss causation's twin – proximate cause.

ARGUMENT

I. The Role of Private Securities Litigation

It has long been recognized that private litigation serves as a "necessary supplement" to public enforcement of the securities laws. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). According to the congressional testimony of then-Securities and Exchange Commission ("SEC") Chairman Arthur Levitt, "Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws." *Common Sense Legal Reform Act: Hearing Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. 1 (1995) (prepared statement), *available at* http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt (last visited Nov. 13, 2004).

Congress enacted the PSLRA, Pub. L. No. 104-67, 109 Stat 737, codified at 15 U.S.C. § 77z-1 to 78u-5, to remedy perceived

abuses in securities litigation. In so doing, Congress emphasized the important continuing role of private plaintiffs in enforcing the nation's securities laws:

> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and other properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.

H.R. Conf. Rep. No. 104-369, at 31-32 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 730-31. In the wake of recent accounting scandals in 2001 and 2002, Congress reiterated the importance of private securities actions when enacting the Sarbanes-Oxley Act of 2002 which, among other reforms, extended the statute of limitations for securities fraud cases. *See* Pub. L. No. 107-204, Title VIII, § 804(a)(b) and (c).[2]

Private enforcement is necessary to our current system of regulation because, as has been widely reported, the SEC does not have the resources to police the entire market. *See* United States Gen. Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302, at 33 (Mar. 5, 2002), *available at* http://www.gao.gov/new.items/d02302.pdf. The New York Times has reported that the SEC is plagued by

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2. Contrary to the argument of Amicus American Institute of Certified Public Accountants, Brief of the AICPA at 25, nothing in the Sarbanes-Oxley Act implies that it was intended to *replace* private action; to the contrary, the extended statute of limitations implies that Congress hoped to *increase* opportunities for private litigation.

high turnover and insufficient resources to conduct the kinds of diligent reviews necessary to ensure against fraudulent filings. *See* Stephen Labaton, *SEC Is Suffering Nonbenign Neglect*, N.Y. Times, July 20, 2002, at B1.

Despite the longstanding reliance on private litigants to shoulder a significant share of the burden of policing the securities markets, many of the briefs submitted by amici contend that the loss causation provision of the PSLRA is intended to alleviate congestion in the federal courts by imposing a drastically heightened burden at the *pleading* phase of any securities fraud action. Such congestion is proved by, among other things, what amici perceive as the large number of securities fraud actions filed in recent years. These arguments read as though the past three years of high-profile corporate scandals never occurred. No mention is made of the fact that 2001 through 2003 saw seven of the ten largest bankruptcies in this country's history – including Worldcom, Enron, Global Crossing, and Adelphia – of which at least three have led to criminal prosecutions for accounting fraud. *See Largest Bankruptcies, 1980-Present*. Infoplease (Nov. 16, 2004) *available at* http://www.infoplease.com/ipa/A0904494.html (last visited on Nov. 16, 2004). Nor is there mention that the Food and Drug Administration has become so concerned about biotechnology companies overstating the prospects of approval of new products that it has been working with the SEC to set aside its traditional secrecy about pending applications in order to prevent securities law violations. *See* Ross Kerber, *Regulators Outline Actions to Oversee Drug Firms' Claims: FDA, SEC Would Share Information*, Boston Globe, Feb. 6, 2004, at C3. Nor is any mention made of the fact that some of the most prominent names on Wall Street have recently been repeatedly entangled by SEC and other investigations involving fraudulent

accounting practices,[3] the undue influence of investment banking interests on securities research,[4] and fraudulent initial public offerings allocation practices.[5] In other words, amici overlook the most obvious explanation for any increases in litigation during the past few years: an increase in the occurrence of securities fraud.

Given continued congressional reliance on private enforcement of the securities laws and the recent exposures of extensive corporate malfeasance, it is not appropriate to interpret every provision of the PSLRA as though it was intended to heighten plaintiffs' burden at the outset of a case and facilitate dismissals on the pleadings. Rather, the PSLRA has a number of different provisions, all intended to affect different stages of litigation. Although the PSLRA does contain specific provisions intended to impose heightened pleading burdens, these provisions are clearly identified by the statutory text, and the loss causation provision is not among them.

II. The Scheme of the PSLRA

A. The PSLRA's Multiple Reforms are Targeted at Distinct Phases of Litigation

The PSLRA effected a wholesale reconfiguration of the procedures in securities lawsuits, from the very first filings of a complaint through to liability and damages limitations and settlement procedures.

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3. *E.g.*, The SEC Charges Merrill Lynch, Four Merrill Lynch Executives with Aiding and Abetting Enron Accounting Fraud, Accounting and Auditing Enforcement Act Release No. 1742, 79 S.E.C. Docket 2533 (Mar. 16, 2003).

4. *E.g.*, SEC Sues Merrill Lynch and Henry M. Blodget for Research Analyst Conflicts of Interest: firm and Blodget Settle With SEC, NASD, and NYSE, Release No. 18115, 80 S.E.C. Docket 319 (Apr. 28, 2003).

5. *E.g.*, *SEC v. Credit Suisse First Boston Corp.*, [2001-2002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91, 695 at 98, 123 (D.D.C. Jan. 29, 2002).

With respect to the initiation of a securities class action, the PSLRA created a set of procedures for determining which investor will serve as the lead plaintiff, with the express purpose of encouraging institutional investors, such as pension funds, to take a more active role in the litigation. 15 U.S.C. § 78u-4(a)(3)(B).[6] The statute places limits on the use of "professional plaintiffs" by forbidding any single plaintiff from serving as lead more than five times in a three-year period, 15 U.S.C. § 78u-4(a)(3)(B)(vi), and forbids the lead plaintiff from receiving compensation over and above that received by other class members, 15 U.S.C. § 78u-4(a)(4).

The lead plaintiff selects lead counsel for the Class, 15 U.S.C. § 78u-4(a)(3)(B)(v), and, typically, files a new consolidated complaint that will govern the action. *See generally* Clifford Chance LLP, *Defending Securities Class Actions*, SH083 ALI-ABA 177 (2003). Certain statutory provisions are aimed at complaints, specifically: the PSLRA provides that a complaint must not only specifically identify false statements and the reasons why they are false, but, for allegations made on information and belief, the complaint must "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). For allegations of scienter, the pleading requirements are even more stringent: "the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

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6. A recent survey by PricewaterhouseCoopers shows that this effort has been successful. The rate of unions and public pension funds appointed as lead plaintiffs has grown steadily from 1996 to 2003. *See* PricewaterhouseCoopers LLP, *2003 PricewaterhouseCoopers LLP Securities Litigation Study* 6, (*available at* http://www.10b5.com.)

Additionally, the PSLRA imposes a stay of discovery until the resolution of any motions to dismiss. 15 U.S.C. § 78u-4(b)(3)(B). Thus, plaintiffs must meet these heightened pleading requirements without any formal access to internal corporate documents or the testimony of employees. Notwithstanding this fact, courts have often stated that plaintiffs must identify specific internal reports and their contents. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 942 n.20 (9th Cir.) (disregarding allegations of the existence of internal reports because precise contents not alleged), *cert. denied*, 124 S. Ct. 433 (2003); *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000) ("Where plaintiffs contend defendants had access to contrary facts, they must specifically identify the reports or statements containing this information.").

Once a complaint has survived a motion to dismiss, the case moves into discovery and the class certification stage.[7] After the class has been certified the PSLRA permits courts to require an undertaking from the parties or their counsel to ensure the payment of any fees or expenses that may be awarded. 15 U.S.C. § 78u-4(a)(8).

The statute goes on to impose certain substantive requirements as the case is developed. Plaintiffs must "prove" loss causation, 15 U.S.C. § 78u-4(b)(4), and projections or forecasts of future performance are immunized unless the plaintiff proves that they were made with "actual knowledge" of their falsity, 15 U.S.C. § 78u-5(c)(1), heightening the standard over the recklessness that would ordinarily satisfy the scienter

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7. A recent amendment to the Federal Rules of Civil Procedure provides that a court of appeals, in its discretion, may permit an immediate appeal from an order of the district court granting class certification. Fed. R. Civ. P. 23(f); *see, e.g.*, *Hevesi v. Citigroup Inc.*, 366 F.3d 70 (2d Cir. 2004).

requirement, *see, e.g., Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996).

In the trial phase, the statute grants defendants the right to request written interrogatories of the jury on the question of scienter at the time of the violations, 15 U.S.C. § 78u-4(f)(3).

At the conclusion of litigation, the PSLRA controls damage awards and settlements. The statute replaces the old scheme of joint and several liability with a scheme of proportionate fault, 15 U.S.C. § 78u-4(f), and if some, but not all, defendants settle, the statute requires the entry of an order barring contribution claims made by or against the settling defendants, 15 U.S.C. § 78u-4(f)(7). In the "lookback" provision, damages awarded to any single plaintiff are capped at the difference between the price paid and the "mean trading price" of that security in the 90 days following a corrective disclosure. 15 U.S.C. § 78u-4(e). Proposed settlements must be communicated to the Class in great detail, including the per-share settlement amount and the expected per-share award if plaintiffs prevailed at trial. 15 U.S.C. § 78u-4(a)(7).

Finally, the PSLRA provides that attorneys' fees may not exceed a reasonable percentage of amounts actually paid to the Class. Upon completion of the litigation, the court is specifically directed to review the conduct of the attorneys and impose any appropriate sanctions under Rule 11. 15 U.S.C. § 78u-4(c).

B. The PSLRA has Substantially Altered Private Securities Litigation

The PSLRA has had a major impact on the practice of securities law, particularly at the pleadings stage, where plaintiffs are required to draft highly-detailed complaints without benefit of discovery. As a practical matter, plaintiffs often rely on employees and former employees of the defendant corporation – limited by a patchwork of state laws regarding the

permissibility of such contacts[8] – who are willing to come forward and discuss what they know, or supply plaintiffs with documentary evidence of their claims. *See, e.g., ABC Arbitrage v. Tchuruk*, 291 F.3d 336, 352-54 (5th Cir. 2002); *Novak*, 216 F.3d at 313. As a result of these stringent requirements, it is common for even very detailed complaints to be dismissed on the pleadings. *See, e.g., Goldstein v. MCI Worldcom*, 340 F.3d 238 (5th Cir. 2003) (affirming dismissal of securities fraud complaint against Bernard Ebbers and Scott Sullivan of Worldcom for failure to plead that the defendants acted with intent); *In re Tyco Int'l, Ltd. Sec. Litig.*,, 185 F. Supp. 2d 102 (D.N.H. 2002) (dismissing securities fraud complaint against Tyco as insufficiently detailed).

Indeed, even when plaintiffs supply statements from witnesses and documentary evidence in support of their claims, there is no guarantee that the complaint will survive a motion to dismiss. *In re Cabletron Systems, Inc.*, 311 F.3d 11 (1st Cir. 2002), for example, involved a review of a district court's decision to dismiss a complaint containing information from several former employees who claimed to have been aware of specific fraudulent practices, including the invention of fictitious sales. *Nursing Home Pension Fund, Local 144 v. Oracle Corporation*, 380 F.3d 1226 (9th Cir. 2004), examined a district court's dismissal of a complaint that included statements from at least 44 confidential witnesses, documentary evidence, and

8. For instance, some states place limits on contacts with former employees who were members of the corporate control group or whose actions underlie the lawsuit, *see, e.g.*, South Carolina Bar Ass'n Ethics Advisory Op. 92-31 (1992); South Carolina Bar Ass'n Ethics Advisory Op. 94-25 (1994); *Lang v. Superior Court*, 826 P.2d 1228 (Ariz. Ct. App. 1992); *Porter v. Arco Metals Co.*, 642 F. Supp. 1116 (D. Mont. 1986), other states place no such limits, *see, e.g., Cram v. Lamson & Sessions, Co.*, 148 F.R.D. 259 (S.D. Iowa 1993); *Fulton v. Lane*, 829 P.2d 959 (Okla. 1992).

expert financial analysis. Both of these decisions were reversed on appeal, but only after extensive litigation; moreover, the federal reporters contain several similar examples for which no appeal was apparently taken, or in which dismissals were affirmed on appeal. *See, e.g., Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353 (5th Cir. 2004) (actions based on public corporate documents, such as press releases, must identify which particular individuals drafted or approved the documents and allege facts demonstrating that such individuals acted with intent to defraud); *In re Nike, Inc. Sec. Litig.*, 181 F. Supp. 2d 1160 (D. Or. 2002) (despite allegations of specific reports demonstrating internal problems, complaint dismissed for failure to plead "corroborative facts"); *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308 (M.D. Fla. 2002) (concluding that complaint does not sufficiently describe various situations in which defendants were said to have been advised of the financial problems).

The PSLRA also works in tandem with this Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994) to make it difficult to bring actions against accountants, attorneys, and other peripheral actors. *See Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1206 (11th Cir. 2001) (holding that auditors will not be liable for false statements that they played a role in drafting or editing if the statements are not publicly attributed to the auditor). A typical view was expressed in *In re SCB Computer Tech., Inc., Sec. Litig.*, 149 F. Supp. 2d 334 (D. Tenn. 2001),

> [T]he lack of a rational economic incentive for an independent accountant to participate in fraud, the client's central role in providing information to the accountant, and the complex professional judgment required to perform an audit, make it exceedingly difficult for a securities plaintiff to plead facts

> suggesting that an independent accountant acted with the deliberate state of mind now required to withstand a motion to dismiss.

Id. at 356 (citation omitted).

In short, as one court described it, under the PSLRA, "the gamesmanship required to plead a successful securities claim has taken on a dimension reminiscent of pre-Federal Rules pleading practice." *In re Number Nine Visual Tech. Corp. Sec. Litig.*, 51 F. Supp. 2d 1, 27-28 n.22 (D. Mass. 1999).

The practical effect is that since the enactment of the PSLRA, motions to dismiss are granted with far more frequency. According to two studies, dismissal rates have doubled since the PSLRA took effect. *See* Richard Painter et al., *Private Securities Litigation Reform Act: A Post-Enron Analysis* 7-8, The Federalist Society for Law & Public Policy Studies (June 2002), *available at* http://www.fed-soc.org/pdf/PSLRAFINALII.PDF (last visited Nov. 16, 2004). Moreover, courts have observed that the high pleading standards coupled with the discovery stay have made "motions to dismiss in securities fraud cases . . . all too common where the procedural posture of the case renders most of the defendants' arguments futile." *In re Indep. Energy Holdings PLC Sec. Litig.*, 154 F. Supp. 2d 741, 747 (S.D.N.Y. 2001). A typical securities fraud action may not even begin discovery until two years after the initial filing. *See* Terrence G. Stolly, Comment, *Scienter Under the Private Securities Litigation Reform Act of 1995: Unexpected Implications on Director and Officer Liability and D&O Insurance*, 29 Cap. U. L. Rev. 545, 577 (2001). It is against this backdrop that the PSLRA's loss causation provision must be considered.

III. Loss Causation

A. Proximate Cause Requires Only that the Loss Touch Upon the Fraud

The circuits agree that "loss causation" in securities law is similar to the common law concept of proximate cause, and requires only that the plaintiff show that "the misrepresentation touches upon the reasons for the investment's decline in value." *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983). Loss causation requires that "the damages suffered by plaintiff [] be a foreseeable consequence of any misrepresentation or material omission." *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001).

i. Loss causation is shown if the truth is disclosed to the market

The United States is clearly correct by arguing that loss causation is properly alleged when the artificial inflation is removed from the stock price, typically when the "truth" is revealed to the market either through an actual revelation of fraud, or simply by the fact that the corporation's true financial condition becomes apparent. Brief of United States as Amicus Curiae at 19-21. When one lies about a company's financial condition and inflates the price of the stock, it is always foreseeable that artificial inflation will dissipate when the truth comes out, whether that occurs through a large announcement of a sudden loss, or a series of smaller disclosures over time that provide counterbalancing truthful information about the company.

The case of *In re Control Data Corp.*, 933 F.2d 616 (8th Cir. 1991), illustrates this principle. The company

admitted that it had overstated its earnings, but its announced restatement did not affect the price of the stock. However, after the *Wall Street Journal* pointed out that the new, revised numbers left the company in violation of its loan covenants, its stock price dropped $3 per share. The district court determined that the $3 price drop was attributable not to the fraud, but to the company's failure to disclose its default on the loan covenants. Because the company had no freestanding obligation to disclose the loan covenant status, there was no causation. *See id.* at 617-18.

The Eighth Circuit reversed. In the Eighth Circuit's view, although the earnings overstatement itself may not have caused investors' losses, the false accounting obscured the status of the company's loan covenants. *See id.* at 620. Once the market became aware of the underlying reality of the company's financial condition, the stock price fell. These losses were recoverable.

By contrast, the court erred in *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 273 F. Supp. 2d 351 (S.D.N.Y.), *appeal docketed*, No. 03-9286 (2d Cir. Dec. 1, 2003). There, the plaintiffs alleged that the brokerage firm of Merrill Lynch issued false research reports on various stocks, thus causing the stock prices to rise. When the stock prices crashed, the plaintiffs lost their investment. *See id.* at 359. The district court dismissed the claims on the ground that the chain of causation was broken by the "intervening cause" of the burst of the stock market bubble. *See id.* at 364-65. What the district court apparently failed to realize is that a "burst bubble" is, in reality, a collective realization by the market that a large number of stocks were overvalued relative to their true earnings potential. In other words, a burst bubble is not an unforeseen, unrelated event, like a terrorist attack or an

earthquake, but is simply a shorthand term for disclosure of the truth. Because it is always foreseeable that truth will eventually be revealed, the district court erred in concluding that no loss causation had been shown.

ii. Loss causation is shown if the fraud facilitates the events that cause the decline in value

There are other ways in which a plaintiff might show that the fraud "touches upon" their losses, even if whatever artificial inflation the false statement caused continues to provide a boost to the stock price and has not dissipated merely due to the disclosure of truthful information. For instance, in the traditional manner that proximate cause has always been conceived, the fraud may directly lead to a chain of events which then become the immediate cause of plaintiffs' losses. *See Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003) (loss causation requires showing a "causal link" between the misrepresentation and the harm suffered).

The case of *Semerenko v. Cendant Corp.*, 223 F.3d 165 (3d Cir. 2000), provides a useful example. The Cendant corporation issued a tender offer for the shares of American Bankers Insurance Group (ABI). The market reacted favorably to the news and ABI's stock price increased. Later, Cendant discovered that its financial statements had been fraudulently inflated, and ABI and Cendant jointly announced that the merger would be terminated. *See id.* at 171. ABI's stock price collapsed and ABI shareholders sued Cendant. Cendant insisted that there was neither transaction causation nor reliance, because the direct causes of both the price inflation in ABI stock, and its subsequent collapse, were the decisions to arrange for a merger and to cancel it. *See id.* at 186-87.

The Third Circuit disagreed, explaining that "not every intervening event is sufficient to break the chain of causation." *Id.* at 186; *see id.* ("to allow any intervening change in market conditions not directly caused by the defendant to break the chain of causation and exempt the defendant from liability would eviscerate Rule 10b-5" (citation omitted)). In the Third Circuit's view, the collapse in share price would still have been "caused" by Cendant's fraud if, instead of affecting ABI shares directly, it had led the ABI Board of Directors to conclude that the merger would no longer be beneficial to the company – a decision which, in turn, caused the price collapse. *See id.* at 187.

By contrast, the principle was misapplied in *Robbins v. Koger Properties*, 116 F.3d 1441 (11th Cir. 1997). Koger's accountant, Deloitte, was alleged to have fraudulently certified financial statements that overstated Koger's cashflow. Because Koger paid its cashflow out in dividends, the overstated cashflow led to high dividends and an increase in its stock price. *See id.* at 1444. To maintain these high dividend payments, Koger began selling its assets, which eventually caused its stock to decline during the Class Period. *See id.* at 1444-45. The stock ultimately crashed when Koger cut its dividend. *See id.* at 1445.

The Eleventh Circuit held that there had been no loss causation because the market was still under the mistaken impression that Koger's financial statements had been accurate at the time of the crash, and because it was Koger's inability to sell more of its assets, rather than the overstated cash flow, that led to the dividend cut. *See id.* at 1448-49. This was far too narrow a view of causation.

As the opinion makes clear, Koger's stock price steadily declined as it sold its assets to maintain its dividends. But

its high dividend rate was a direct result of the overstated cash flow approved by Deloitte. In other words, Deloitte's fraud enabled Koger to take the actions that ultimately harmed investors.[9] As for the dividend cut at the end of the Class Period, that too flowed from Koger's financial instability caused by its continuing sale of assets to maintain its dividends. Koger's financial instability was therefore an entirely foreseeable consequence of its creation of fictional cashflow, all of which had been approved by Deloitte. Thus, the "fact misstated was of a nature calculated to bring about such a result that damages for it can be recovered." *Marbury Mgmt., Inc. v. Kohn*, 629 F.2d 705, 718 (2d Cir. 1980) (quotation omitted).

iii. Loss causation is shown if the artificial inflation is no longer recoverable

Finally, the loss must be deemed to have been caused by the fraud if the value of the security has dropped to the point where any artificial inflation in the stock price cannot be recouped through a resale; that is, where the price of the stock has fallen below the amount of the artificial inflation itself (even to the point of insolvency of the company). In that case, whatever portion of the stock price was attributed to the artificial inflation has been removed and is unrecoverable; necessarily, the fraud "touches upon" the investor's loss, and the element of loss causation has been satisfied. Indeed, the United States agrees that so long as the investor may recoup her losses through a resale of the stock, there is no loss

9. This analysis assumes that the United States is correct in concluding that the decline in Koger's stock price as its financial position deteriorated was not simply a method by which the "truth" became known to the market. Brief for United States at 17.

causation, Brief for United States at 21; by the same token, when a resale will no longer permit recoupment, there is loss causation.

The PSLRA itself envisions something similar, as evidenced by its "lookback" provision regarding damages. 15 U.S.C. § 78u-4(e). The "lookback" provision largely codifies the insights of Baruch Lev and Meiring de Villiers in their article *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 Stan. L. Rev. 7 (1994). Lev and de Villiers argued that the then-current method of damage calculation, which assumed that the "true worth" of a company was measured by its share price immediately following a corrective disclosure, substantially undervalued the company and, consequently, overestimated plaintiffs' damages. In their view, certain inefficiencies in trading cause markets to overreact to corrective disclosures with a brief "crash" in stock price, followed by a bounceback to a more appropriate share price, as measured by the true fundamentals of the company. *See id.* at 15-16. They recommended that plaintiffs in shareholder class actions receive damages based not on the share price immediately following disclosure, but instead after a short waiting period, to allow the stock to settle at its true value. *See id.* at 35-36. The PSLRA's legislative history explicitly cites the Lev and de Villiers article. *See* S. Rep. No. 104-98 at 20 & n.58, 104th Cong, 1st Sess 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679.

The lookback provision, then, addresses the problem of market overreaction to announcements of adverse information, and is intended to ensure that shareholders are not compensated for damages that are not attributable to

the fraud, but are instead attributable to residual market inefficiencies.[10] *See* Lev & de Villiers, at 22-23.

Significantly, however, the PSLRA provision has an exception not recommended by Lev and de Villiers: Shareholders who sell their stock before the end of the lookback period *will* recover some of these "crash" damages because the lookback period is shortened for them. 15 U.S.C. § 78u-4(e)(2). Under this exception, a plaintiff who sells immediately after the adverse information is released will recover the full amount of her loss, even though some of that loss was, by hypothesis, caused by the "intervening" event of market inefficiencies.

In other words, Congress reached a fair compromise. Shareholders whose losses are due to intervening causes – *i.e.*, market overreaction – may not recover for those losses *when the market itself* will restore the value to the shares. But where those shareholders' losses are permanent because the stock has been disposed of, then Congress is unwilling to let the burden of the loss fall entirely upon the innocent victim of the fraud, rather than its perpetrator, and at least some damages for the "intervening" event will be awarded. *See* Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. Chi. L. Rev. 879, 897-98 (1998). The situation is therefore similar to one in

10. Notably, the statute does not express any view as to how the market might become aware of a corporation's actual value; the statute merely refers to "information correcting the misstatement or omission." 15 U.S.C. § 78u-4(e)(1). This noncommittal phrasing could refer to a formal announcement, business developments that affect the company, or the gradual release of truthful information about the company's financial condition.

which the artificial inflation is removed from the stock because the stock's price has dropped below the point where overpayment can be recouped through a resale. The market itself can no longer compensate the shareholder and the loss is permanent; at that point, it is the wrongdoer, and not the victim, who must pay the price for the fraud.

B. Petitioner and Amici Confuse Revelation of the Fact of Falsity with Loss Caused by the Fraud

Some amici have argued that losses cannot exist unless there is a formal revelation of the false statements followed by an immediate drop in stock price. In so doing, they confuse revelation of the *fact* of the fraud with the losses caused by the fraud. There are any number of factors that could cause losses to investors while simultaneously preventing the stock market from reacting to a disclosure in the manner that amici describe.

For one thing, the theory of efficient markets has never required that markets be *perfectly* efficient. *See Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1130 (7th Cir. 1993) ("'Efficiency' is not an all-or-nothing phenomenon."); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 528 (7th Cir. 1985) (market efficiency is imperfect because "people cannot interpret information flawlessly"). In *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), where this Court adopted the "fraud on the market" theory of reliance, the Court simultaneously warned that it did "not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price." *Basic*, 485 U.S. at 248 n.28

So, for example, information that is publicly released but not widely publicized, or written in highly technical language, or whose significance is not immediately obvious,

may take a longer time to affect a stock's price. *See In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116 (9th Cir. 1989); *Marksman Partners LP v. Chantal Pharmaceutical Corp.*, 927 F. Supp. 1297, 1307-08 (C.D. Cal. 1996). For this reason, it is not unusual to see fact patterns in which publicly available information has little effect on stock price, but after its significance is highlighted in a *Wall Street Journal* article, the stock price drops. *See, e.g., Oran v. Stafford*, 226 F.3d 275, 280-83 (3d Cir. 2000); *Control Data*, 933 F.3d at 618.

Trading patterns unrelated to the disclosure can affect immediate market reaction. During holidays, trading is typically lighter and market reactions unreliable. *See, e.g.*, Theopolis Waters and Curt Thacker, *Commodities Report: Lean-Hog Contracts Tumble As Supplies Top Expectations*, Wall Street Journal, Jan 2, 2003, at C12 (market reaction uncertain until traders return from holiday). Computerized trading strategies can influence market reaction in ways divorced from the actual content of the information disclosed. *See generally* Jerry W. Markham and Rita McCloy Stephanz, *The Stock Market Crash of 1987 – The United States Looks at New Recommendations*, 76 Geo. L.J. 1993, 2032 (1988).

The presence of such real-world inefficiencies – which *Basic* itself acknowledged – does not undermine *Basic*'s core holding that false information will affect a corporation's stock price. However, such inefficiencies do mean that not all pieces of information are received equally. On a motion to dismiss, when presumptions are drawn in favor of the plaintiff, it is perfectly appropriate to presume that false statements have inflated a stock's market price (subject to rebuttal with evidence at later stages of litigation, *see Basic*, 485 U.S. at 245-46). But that presumption does not, at the

pleading stage, require a court to assume that when the truth is disclosed, the market immediately reacts in perfect tandem to the original fraud.

This principle is demonstrated a line of case law developed in the wake of *Basic* known as the "truth on the market" doctrine. The doctrine posits that truthful information, like false information, will penetrate the market and offset any inflationary effect of the fraud. Although several circuits have accepted the legitimacy of the "truth on the market" rebuttal to "fraud on the market" allegations, *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000); *Asher v. Baxter Int'l Inc.*, 377 F.3d 727, 735 (7th Cir. 2004); *Apple Computer*, 886 F.2d at 1116, they stress that truthful information will not offset false information unless it has been "transmitted to the public with a degree of intensity and credibility sufficient to effectively counter-balance any misleading impression created by the insiders' one-sided representations." *Apple Computer*, 886 F.2d at 1116; *see Ganino*, 228 F.3d at 167 (same). Thus, these courts acknowledge that it cannot be immediately assumed that offsetting truthful information will be incorporated into stock prices with perfect efficiency. As the Second Circuit put it, "the laws of economics have not yet achieved the status of the law of gravity." *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 270-71 (2d Cir. 1993).[11]

Even in an efficient market, other countervailing forces may influence the stock price and prevent a drop immediately

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11. The "lookback" provision of the PSLRA acts as a congressional acknowledgment that markets are not perfectly efficient. As discussed above, the provision is premised on the notion that markets may occasionally "overreact" to bad news and will take some time to settle into an appropriate equilibrium.

following an adverse disclosure. Unsurprisingly, companies do not like to see their stock prices drop and thus may time announcements of bad news to coincide with offsetting announcements of good news. *Cf. Am. W. Holding Corp.*, 320 F.3d at 935 (delay in market reaction due in part to defendant's efforts to assure analysts that there would be no effect on company). Or, unrelated conditions may influence the stock upward so as to offset any negative price effect. The economy generally, or the industry specifically, may be causing market *gains* such that a company's announcement of adverse information only has the effect of keeping the stock price stable. Under such circumstances, there is still a loss to investors in that the stock did not appreciate as it should have. *See Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831-32 (8th Cir. 2003) ("If a stock does not appreciate as it would have absent the fraudulent conduct, investors have suffered a harm.").

The stock price may also appear to remain stable because of the sheer number of shares issued. The more shares, the less each particular share will be affected by damaging news, although even a drop by a few pennies may represent the loss of significant amounts of market capitalization.

Finally, the market may already have accounted for the company's true financial condition at some earlier date. Even before the company admits, say, that earnings were overstated or that it has underreserved for bad debt, the truth may have manifested itself through some related financial crisis, through gradual market skepticism of reported results, through the counterbalancing release of truthful information over time, or – most insidiously – the corporation itself might deliberately deflate its stock price with false "bad" news in

order to prepare the market for news of the fraud. As this Court observed in *Basic*

> We note there may be a certain incongruity between the assumption that Basic shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements. Proof of that sort is a matter for trial. . . .

485 U.S. at 249 n.29.

The more remote in time the original fraud, the more likely that the market price may have already corrected for the artificial inflation. *Cf. Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 n.3 (9th Cir. 1987) (noting that "the prolonged nature of the fraud may have introduced other market variables which affected the amount the market reacted to the disclosure."). Moreover, if the fraud is remote in time and the market perceives that the stale information is unlikely to have significant effects on company performance going forward, this too may leave stock prices unaffected, even if, at some earlier point, stock prices were inflated as a result of the fraud with accompanying losses to shareholders once equilibrium was restored. *See Control Data*, 933 F.2d at 620 n.8; *cf. Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 514 (7th Cir. 1989) ("Investors value securities because of beliefs about how firms will do tomorrow, not because of how they did yesterday.").

C. Loss Causation Need Not Be Pled With Particularity

Some amici contend that complaints must be dismissed unless they contain detailed allegations regarding the inflationary and deflationary effects of the false statements and the eventual disclosure of the truth. Such detailed pleading is not required by the PSLRA or the Federal Rules of Civil Procedure.

"Where, as here, the statute's language is plain, the sole function of the courts is to enforce it according to its terms." *United States v. Ron Pair Enters.*, 489 U.S. 235, 241 (1989) (quotations and citations omitted). The PSLRA requires only that plaintiffs "have the burden of proving," not pleading, loss causation. 15 U.S.C. § 78u-4(b)(4). This provision stands in marked contrast to other PSLRA provisions that specifically target contents of complaints. *Compare* 15 U.S.C. §§ 78u-4(b)(1), 78u-4(b)(2). It is also significant that paragraph (b)(3) of the PSLRA instructs courts to grant motions to dismiss "if *the requirements of paragraphs (1) and (2) are not met.*" 15 U.S.C. § 78u-4(b)(3)(A) (emphasis added). This provision does not mention paragraph (b)(4) dealing with loss causation. *Id.* The natural conclusion is that while failure to *prove* loss causation will defeat a claim, the PSLRA imposes no special pleading requirements with respect to loss causation beyond those ordinarily required by the Federal Rules of Civil Procedure. *See ConAgra*, 335 F.3d at 830 n.3.

Contrary to the assertion of the United States, Brief of United States at 15, loss causation need not be pled with particularity under Rule 9(b).[12] Rule 9(b) provides that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The courts of appeals have uniformly interpreted the phrase "circumstances constituting fraud" to mean the time, place, and content of the alleged false representation, and the identity of the person making the false statement. These courts do not require special pleading of other

12. Even if Rule 9(b) did require pleading loss causation with particularity, some courts have held the PSLRA supercedes reliance on 9(b) in securities fraud cases. *See In re Navarre Corp. Securities Litigation*, 299 F.3d 735, 742 (8th Cir. 2002); *Lipton v. PathoGenesis Corp.*, 284 F.3d 1027, 1034 n.12 (9th Cir. 2002).

elements of the action. *See, e.g., Edwards v. Marin Park, Inc.*, 356 F.3d 1058, 1065-66 (9th Cir. 2004); *Yuhasz v. Brush Wellman, Inc.*, 341 F.3d 559, 563 (6th Cir. 2003); *United States ex rel. Willard v. Humana Health Plan of Texas Inc.*, 336 F.3d 375, 384 (5th Cir. 2003); *Schaller Tel. Co. v. Golden Sky Sys., Inc.*, 298 F.3d 736, 746 (8th Cir. 2002); *Bd. of Trs. v. Foodtown, Inc.*, 296 F.3d 164, 173 n.10 (3d Cir. 2002); *Caputo v. Pfizer, Inc.*, 267 F.3d 181, 191 (2d Cir. 2001); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1202 (11th Cir. 2001).

"Circumstances constituting fraud" are pled with particularity in order to give sufficient notice to defendants to respond to the charges, *see, e.g., Novak v. Kasaks*, 216 F.3d 300, 312 (2d Cir. 2000), and to deter the filing of frivolous fraud claims, *see Ackerman v. Northwestern Mut. Life Ins. Co.*, 172 F.3d 467, 469 (7th Cir. 1999). Neither of those purposes is served by requiring detailed pleading of loss causation in the securities context.

The "notice" intended to be imparted by Rule 9(b) particularity is notice of the type of fraud alleged, because "fraud" is generally thought to be an amorphous concept. As this Court stated:

> 'Fraud is infinite, and were a Court of Equity once to lay down rules, how far they would go, and no farther, in extending their relief against it, or to define strictly the species or evidence of it, the jurisdiction would be cramped, and perpetually eluded by new schemes which the fertility of man's invention would contrive.'

SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 n.41 (1963) (*quoting* Letter of Lord Hardwicke to Lord Kames, dated June 30, 1759). This sort of notice is not enhanced by the detailed pleading of loss causation; the PSLRA's requirement

that complaints "state with particularity all facts" that form the basis for plaintiffs' belief in the falsity of defendants' statements, 15 U.S.C. § 78u-4(b)(1), provides defendants with all the notice that they require.

Nor is heightened pleading of loss causation necessary to deter frivolous lawsuits, because the PSLRA's heightened pleading requirements ensure that cases will only proceed to discovery after plaintiffs have alleged facts that create a "strong inference" that the defendants acted with an intent to defraud. Not only is this requirement sufficient to weed the frivolous from the potentially meritorious, but any further requirements in this respect run the risk of burdening meritorious, rather than frivolous, claims.

It would not be helpful to a court or to the parties to require detailed pleading of loss causation. As is clear from the above discussion, complicated market forces will affect stock price movements at different times. The "truth" about a corporation's condition may slowly be disclosed to the market over a prolonged period, and deflation of the stock price may correspondingly be a slow process, affecting those who buy and sell during the Class Period differently from those who hold their stocks through the end of the Class Period. Fraud in one area of a corporation may affect other aspects of the corporation's public disclosures, and other market variables may interact with the fraud in ways that affect the amount of losses. *See Wool*, 818 F.2d at 1437 n.3. The disclosure of apparently unrelated business problems that appear to be "intervening events" influencing the stock price may turn out to be related to the fraud, or timed to impact market reaction. It is simply impossible for these kinds of factors to be estimated without access to discovery and

without the use of expert opinion. *See Emergent Capital*, 343 F.3d at 197 ("[I]f the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not have been established. But such is a matter of proof at trial and not to be decided on Rule 12(b)(6) motion to dismiss."). If plaintiffs were required to plead detailed loss causation theories in their complaints, courts would be required to assess their viability in the inevitable motion to dismiss – all without access to the tools and evidence necessary to make an informed decision.

Amici insist that a vigorous loss causation pleading requirement is necessary in order to avoid reliance on vague expert studies that may not properly quantify losses attributable to the fraud. To begin, many of these arguments confuse *loss causation* with damages; as the United States concedes, Brief of United States at 16 n.1, these are different concepts and involve different sorts of evidence. *Cf. Restatement (Second) of Torts* § 7 (1965) (distinguishing between "injury," which forms the basis for a lawsuit, and "harm," which constitutes actual damage); *see also Miller v. Asensio & Co.*, 364 F.3d 223, 229 (4th Cir. 2004) ("[A]lthough courts use 'damages' (as well as 'injury,' 'harm,' or 'loss') in discussing liability in 10b-5 cases, they employ that term to resolve a different question than the amount of recoverable damages."). Additionally, there is not so much as a hint that Congress was concerned with problems of *evidence* when it crafted the PSLRA, and amici offer no explanation for why this Court should presume that the loss causation element of a 10b-5 action was intended to replace Federal Rules of Evidence as a mechanism to ensure the reliability of proofs. It is also difficult to see how problems of proof will be remedied by moving the trial up to the pleadings stage and

requiring the court to resolve such issues *without* the benefit of evidence.[13]

The fallacy of requiring detailed loss causation pleading is made clear in *D.E.&J Ltd. P'ship v. Conaway*, 284 F. Supp. 2d 719 (E.D. Mich.), *appeal docketed*, Nos. 03-2334, 03-2417 (6th Cir. Oct. 3, 2003). In that action, the Kmart corporation suffered from a deteriorating financial condition which ultimately led it to file for bankruptcy. The plaintiffs alleged that Kmart had attempted to conceal its condition with false financial statements. The district court, however, concluded that plaintiffs had failed to allege loss causation, for two reasons. First, the district court made the same error involved in *Merrill Lynch*: it mistook an event that brought

13. Amicus Merrill Lynch describes what it terms the "speculative" proof offered in cases currently pending before the district courts regarding allegations that it engaged in fraudulent and manipulative IPO allocation practices and exerted undue influence on its research analysts for the benefit of its investment banking operations. Obviously, the reliability of the proofs offered in those actions is not something that this Court is called upon to decide. Additionally, the loss causation questions in those cases differ in significant ways from the allegations in the current matter because plaintiffs in those actions allege intentional market manipulation through conduct, rather than through false statements alone. *See* 17 C.F.R. § 240.10b-5(a),(c). What is clear, however, is that the State of New York considered the conduct at issue in the analyst conflict actions to be sufficiently damaging to investors that it fined Merrill $100 million and required it to make sweeping structural reforms. See Press Release, New York Attorney General (May 21, 2002) ("Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices"), *available at* http://www.oag.state.ny.us/press/2002/may/may21a_02.html. Moreover, many of Merrill Lynch's arguments appear to be directed more toward transaction causation, *i.e.*, whether the conduct had any effect on stock price in the first instance, rather than toward loss causation, which is the issue before the Court.

the truth to light for an intervening cause, deciding that certain drops in Kmart's stock price could be attributed to the "intervening cause" of the bankruptcy itself. *See id.* at 749 n.26. The district court's second error was to hold that the decline in Kmart's stock price prior to the bankruptcy could not be attributed to the company's deteriorating financial position, and instead was due to the events of September 11 and the war in Afghanistan. *See id.* at 749 n.26. The district court came to this conclusion solely by performing its own comparison of Kmart's stock price to the market generally, taking judicial notice of facts about market performance that had not been included in the complaint. But it should be obvious that such a crude comparison might easily miss other relevant factors, such as the performance of other retailers or Kmart's own performance history. These sorts of issues cannot be resolved at the pleadings stage.

IV. The Complaint Meets Rule 8 Pleading Standards for Loss Causation

Because nothing in the PSLRA or the Federal Rules of Civil Procedure requires that allegations of loss causation be plead with any particularity, it is sufficient if this aspect of the complaint meets the requirements of Rule 8, namely, that it contain a "short and plain statement of the claim showing that the pleader is entitled to relief." Fed. R. Civ. P. 8(a)(2). The complaint need not "set out in detail the facts upon which [the plaintiff] bases his claim" so long as the defendant is given "fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Conley v. Gibson*, 355 U.S. 41, 47 (1957). As this Court held in *Swierkiewicz v. Sorema N.A.*, 534 U.S. 506 (2002), "This simplified notice pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims." *Id.* at 512.

Here, the complaint alleges that Class Members were harmed as a result of the false statements of the defendants, while providing exceedingly detailed allegations regarding the nature of the fraud itself. The complaint thus satisfies applicable pleading standards and the Ninth Circuit's decision should be affirmed. *See EP Medsystems, Inc. v. Echocath, Inc.*, 235 F.3d 865, 885 (3d Cir. 2000) (loss causation pled by asserting that defendant's false statements caused financial loss to plaintiff).

CONCLUSION

In sum, nothing in the PSLRA suggests that the loss causation requirement was intended to heighten plaintiffs' pleading burden or to serve a "gatekeeper" function to permit courts to dismiss more easily securities fraud cases. Rather, other provisions of the PSLRA are intended to facilitate early dismissals, and these provisions are clearly marked. The complaint in this action is sufficient to meet notice pleading standards for the element of loss causation, and the Ninth Circuit's decision should be affirmed.

Respectfully submitted,

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